New Policy Institute

Beneath the bonnet: how sound is Britain's economic recovery?

Is the UK economy set fair for growth or is it already under strain?

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Contents

About the authors

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Corry, Kenway and Barwick previously co-authored *A New Golden Rule: putting the corporate sector surplus at the heart of economic decision making*, published by the Fabian Society in 2012.

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Introduction and summary

The UK economy has had a difficult time since the global banking crisis led to what many call the great recession of 2008 and 2009. Calculations vary of exactly how much output we have 'lost' since then as a result of deviating from the historical trend. A figure of around 15% gives a feel of how severe the experience has been.

On the face of it the economy looks to be into a good recovery phase. After many quarters of low or negative growth since 2010, 2014's 2.7%, was the highest rate of growth since 2006 and above the long term average. Employment has grown strongly. The public sector deficit is less than half what it was at its peak in 2010. On the basis of these factors the outgoing Coalition government has naturally made claims that its policies have been working.

Our question is: how well founded is this recovery? After the dotcom bust in the early to mid-2000s, the economy looked to be doing quite well too. In a previous report, *A New Golden Rule* (2012), we showed how a look under the bonnet at that point would have revealed signs of things amiss. A deeper look at what was happening then might have led to better policy making.[1] We are taking the same approach here, this time while there is still time to respond.

This paper uses headline statistics to make five points.

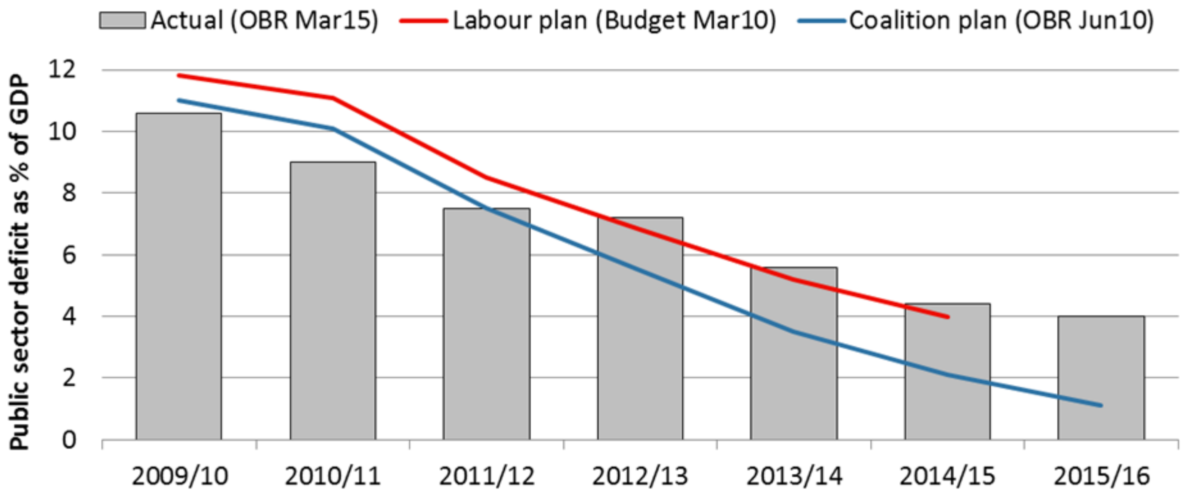
1. Contrary to the denials, the Coalition ended up adopting a plan B for deficit reduction. That plan – in terms of the path followed by the deficit as it came down – was the one advocated by Labour, to reduce the deficit by half during a five year term. The Coalition followed its own plan for about two and half years before switching track.
2. Both the total number in work and the employment rate are at record levels but nearly half of the growth since 2009 has been in self-employment – a far bigger share than is normal. At the same time, income from self-employment has fallen steeply.
3. Labour productivity grew strongly after the recessions in the 70s, 80s and 90s, whereas it has barely grown at all since 2009. Without productivity growth, real wages cannot grow while the choices governments must make are far harder.
4. As with productivity, so with household income: instead of rebounding sharply as it did after each of the last three recessions, real household disposable income is barely up on where it was in 2009.
5. The 4.5% deficit now is the same as it was 19 years ago during the recovery from the early 1990s recession. But at that time, the other sector balances, for households, companies and with the rest of the world, were set fair for sustained economic growth. The current situation, with households spending to the hilt and a big balance of payments deficit, looks like the end of a period of growth, not the early stages.

Behind a steadily falling public sector deficit, the UK economy is both weak and unbalanced. Higher exports and higher investment would be a cure. But standard macroeconomic policies, both fiscal and monetary, cannot make them happen. Unconventional monetary policy, in the shape of quantitative easing, came to the rescue in 2009. Other 'unconventional' economic policies are now needed. Deficit reduction is desirable; but it is nowhere near enough.

[1] https://www.fabians.org.uk/publications/a-new-golden-rule/

1. Deficit reduction: plan B after all

The Coalition stuck to its own deficit reduction path for two years – then switched tracks in 2012/13 to follow Labour's path instead



Source: public sector net borrowing as percentage of GDP: HM Treasury Budget table C2 March 2010; OBR Budget Forecast table C1 June 2010; OBR Economy Supplementary table 1.10 March 2015.

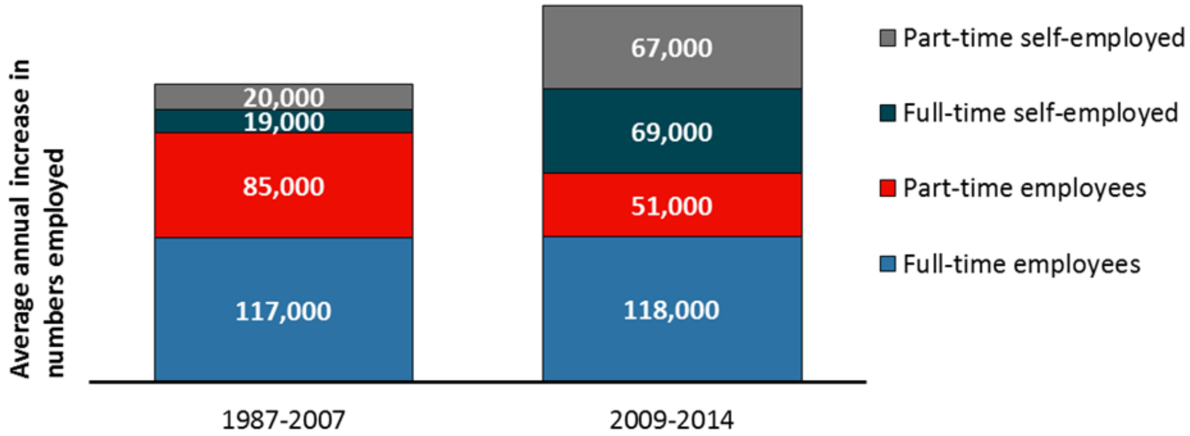
When the Coalition took office in May 2010, it inherited a level of public sector spending that had exceeded public sector revenue in the year just ended by 11% of GDP. The deficit ballooned as the recession shrank the economy, cut tax receipts and saw spending rise both automatically (e.g. on social security) and by choice (e.g. to support the banks). All agreed the deficit had to come down; any new government would have made reducing it a priority. The disagreements were about the pace of reduction and the mix of tax rises, spending cuts and economic growth to use. The June 2010 Emergency Budget set out the Coalition's plan.

For two years, the deficit came down in line with that plan. Criticised for cutting too far too fast, the Coalition insisted there was no alternative, no plan B. Yet by the end of its third year, 2012/13, a gap was opening up between plan A (a deficit of 5.5%) and what was actually happening (7.2%). As the gap widened in 2013/14 (3.5% versus 5.6%), not only was it clear that plan A had indeed been abandoned but also that plan B was in fact … the path for the deficit that Labour had set out in its last Budget just before the 2010 election. That budget had foreseen a 4% deficit in 2014/15. The outcome is expected to be 4.4%. The mix of tax, spending and growth is different from Labour's; but the deficit path is the same.

In telling this story, we're taking some poetic licence with the numbers: for example, the deficit's measured slightly differently now than it was in 2010. But that does not alter the simple message that on deficit reduction, the Coalition has brought us to the point that Labour had said it hoped to reach. If that's how the last five years have turned out, so could the next five: arguments about the path of the deficit are a diversion. Instead of fixating on the deficit, other parts of the next government's economic inheritance need much more attention. Here are a few of them.

2. Employment: record numbers, uncertain quality

Employment is up strongly since 2009 but nearly half that growth has been in self-employment – a far bigger proportion than is normal



Source: ONS Labour Market Statistics March 2015 (series identifiers YCBK, YCBN, YCBQ, YCBT)

Employment growth since 2009 has been strong. Both the number employed – 30.9 million – and the employment rate among those aged 16 to 64 – 73.3% – at the end of 2014 were records. As the chart shows, employment has grown more strongly since 2009 (310,000 a year) than the long term average up to 2007 (240,000 a year).[2]

But it is not just the number that stands out: the mix has changed too. The number of full-time employees has continued to grow at exactly the same pace as before. The growth in the number of part-time employees has slowed. But the growth in self-employment has soared from just under 40,000 a year up to 2007 to almost 140,000 a year since 2009. Up to 2007, self-employment accounted for 16% of annual growth; now it is 45%.

Are these all "good" jobs, the basis of sustainable, balanced prosperity? Over the long term, self-employment grows faster in some periods than others. But the more than threefold increase after 2009 is suspicious. Official statistics published last year showed that average (median) income from self-employment was 22% lower in 2012/13 than four years earlier (and 31% lower than the pre-crash peak six year earlier). Self-employed jobs that aren't paying much at all will be part of the reason for this steep fall in average income.[3] Some of these self-employed jobs cannot be good jobs.

On top of this, 700,000 people were relying on a zero-hours contract as their main form of employment at the end of 2014. [4] This figure is 500,000 higher than five years earlier although as the ONS notes, heightened awareness of these contracts is a factor behind the increase. Neither self-employment nor zero hours are inherently bad: for example only one third of those with zero reported wanting to work more hours. But the growth in both since 2009 shows why this jobs recovery has not felt as strong as the headline statistics suggest.

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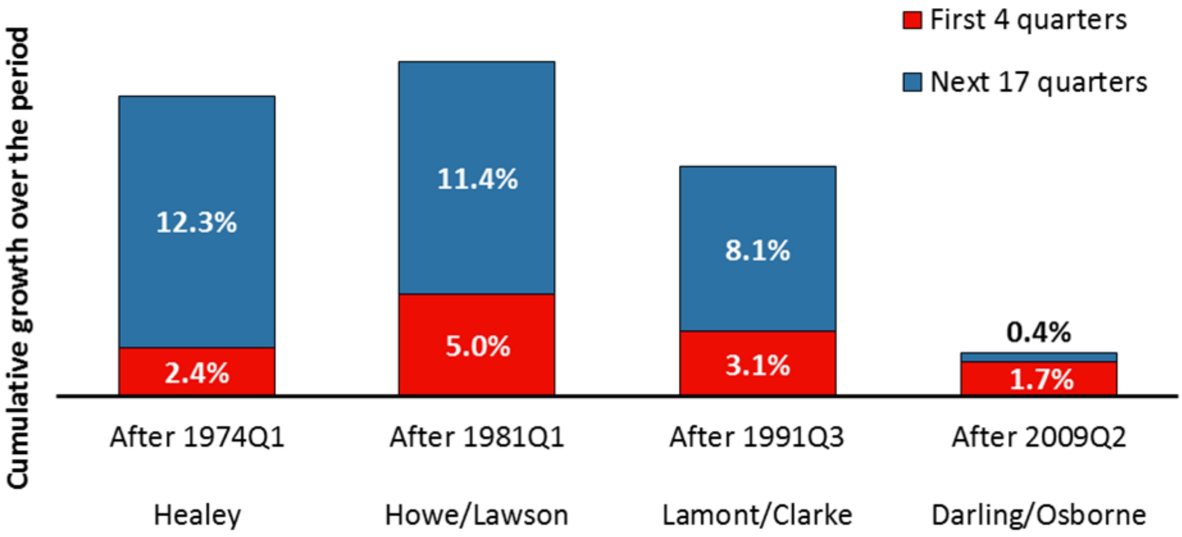
2 The 20 year period for the long term average has been chosen to be the same as that used below for the sector financial balances.

3 http://www.ons.gov.uk/ons/rel/lmac/self-employed-workers-in-the-uk/2014/rep-self-employed-workers-in-the-uk-2014.html.

4 http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-392551

3. Productivity growth: flat on the floor since 2009

Five years after the recessions of the 70s, 80s and 90s had ended, productivity per hour had grown by between 11% and 16%. Since 2009 it has grown 2%.



Source: ONS Labour Market Statistics January 2015 whole economy output per hour worked (series identifier LZVB). Computed as averages over four and 17 quarters.

Record employment should have meant surging economic growth and rising incomes. But it hasn't. The reason is to do with labour productivity. Except in recessions, labour productivity – measured here by output per hour – tends to edge up, slowly but fairly steadily. That is no longer the case.

With now five and a quarter years of data since the end of the recession in mid-2009, the chart shows what happened to productivity in both the first year after each of the last four recessions had ended – and then the next 17 quarters. In the first year, the productivity rebound after 2009 was weaker than in any of the earlier three. But what has happened since is beyond compare: virtually zero productivity growth under Osborne compared with 12% under Healey, 11% under Howe and Lawson and 8% under Clarke.

Since it is productivity growth that makes sustained growth in earnings possible, this matters politically as well as economically. Of course, the flipside of the poor productivity record is higher employment but in terms of the underlying health of the economy that does not alter the facts: the collapse of productivity growth is the biggest economic failure during the Coalition years and the most perplexing one for future economic growth.

International comparisons over the four years to 2013 show the UK at bottom of the list of the G7 advanced economies: 1.9% compared with 4.6% for the rest of the G7.[5] There is much debate about the causes of low productivity growth and clearly there are no easy answers. But some honesty about the difficulties – getting away from the idea that it will all take care of itself if only the public deficit comes down – would be a start.

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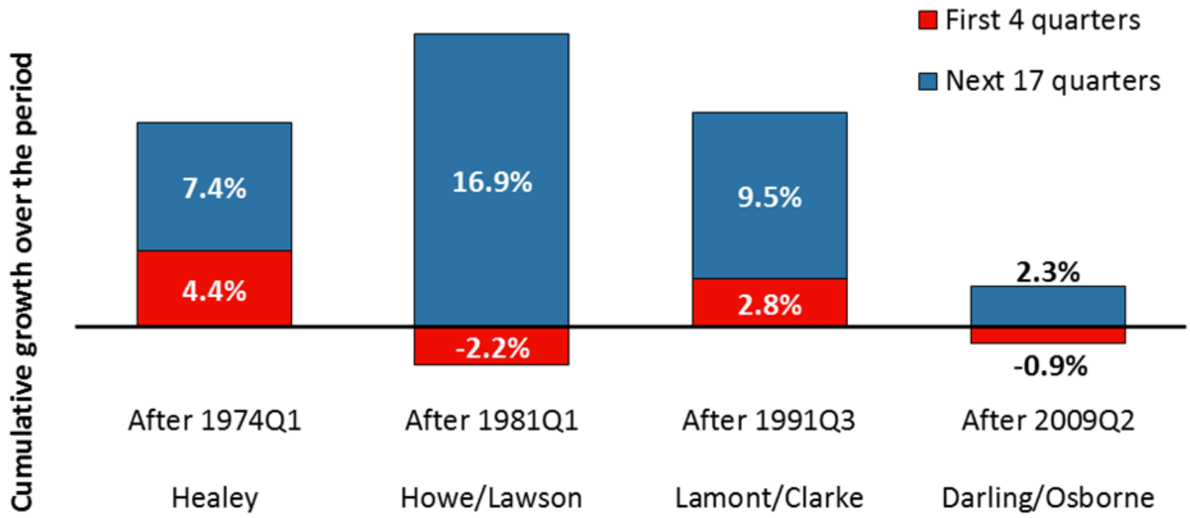
5 http://www.ons.gov.uk/ons/rel/icp/international-comparisons-of-productivity/2013---final-estimates/rftxl-icp0215.xls: table 3.

4. Household income: flat on the floor since 2009

Five years after the recessions of the 70s, 80s and 90s had ended, real household disposable income had grown by 12% to 15%. Since 2009 it's grown by only 1.5%



Source: ONS Quarterly National Accounts, series identifiers RPHQ, ABJQ, HAYE, ABJR, HAYO. The construction of consumer expenditure deflator as per OBR Economy Supplementary table 1.7 March 2015.

This chart, showing the change after inflation in households' post-tax disposable income over the 21 quarters since the end of each of the last four recessions, has been drawn on the same basis as the chart on labour productivity. The resemblance is striking: once again, the record since 2009 is completely different from earlier years. Instead of an increase of between 12% and 15% (1970s, 1980s and 1990s) the total since 2009 is 1.4%.

There are various ways of measuring 'real' incomes which present very different pictures of what has been happening in recent years.[6] The measure of real household disposable income used here paints one of the rosier possible pictures.

The importance of this chart can hardly be over-stated. First, it underlines how significant the failure to get labour productivity growing again has been in terms of how well off households are and are feeling – a key political factor.

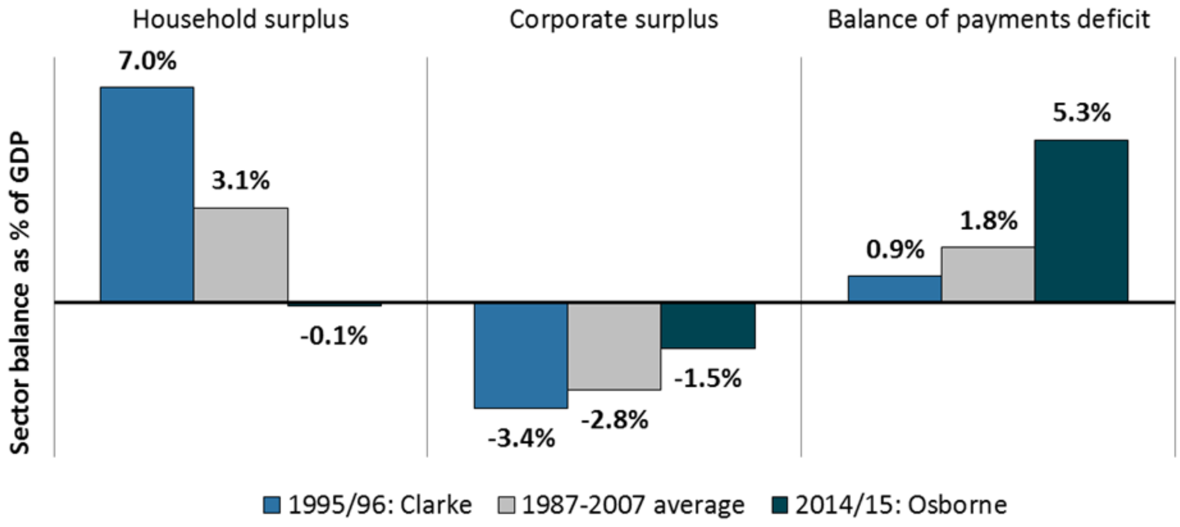
Second, this slow growth in real household income will be part of the explanation as to why households are saving at a rate well below their long run average, something that matters since low savings are unlikely to mean a balanced economy in the medium term.

Third, even when cuts to public expenditure come to an end, if disposable household income hasn't started rising, 'true' austerity won't be over – and nor will it feel like it.

6 See http://blogs.ft.com/ftdata/2015/03/04/what-has-really-happened-to-living-standards/

5. A lower deficit but an ill-balanced economy

The last time the public sector deficit was where it is today, the other parts of the economy were much better aligned than they are now



Source: OBR Economy Supplementary table 1.10 March 2015 (for 2014/15) and ONS Quarterly National Accounts February 2015 (for 1995/96 and 1987-2007: series identifiers RPYN, RPZT, RQBV, RQCH, ABMI). [7]

The public sector deficit is one of four sector financial balances that together have to sum to zero. One way of expressing the connection is that the public sector deficit equals: a) the surplus of the household sector; plus b) the surplus of the corporate sector; plus c) the balance of payments deficit. Each sector balance can be a problem in its own right. The state of the economy is better judged by looking at all of them and not just one. The chart shows these other balances for two years, 1995/96 and 2014/15, both of which had a public sector deficit of about 4.5% and both of which came a few years after a deep recession.

1995/96 was the third year of what became an eight year golden economic age. The chart hints at why. In that year, the 4.5% deficit was matched by a household sector still saving like mad (+7.0%), a corporate sector borrowing to invest (-3.4%) and only a small balance of payments deficit (0.9%). This economy, where the main policy challenge was to encourage households to spend more, was in good shape.

2014/15 is very different. The household sector needs to save more not less. The balance of payments deficit (5.3%) is well above its long term average (1.8%). The corporate sector deficit (the first since 2002) is a relatively bright spot but (at -1.5%) is pulling the economy a lot less strongly than it was in 1995/96.

An export boom, to shrink the balance of payments deficit and encourage firms to invest more in pursuit of export markets, would be ideal. But encouraging foreigners and companies to spend more is not easy at all. The public deficit may be coming down but the economy is not rebalancing as it needs to which spells trouble for the strength of the economy in the next period.

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[7] The 20 year average reflects the full period for which ONS data is available. The OBR's numbers for 2014/15 add to 3.7% not 4.4%. Where the 0.7% error ends up falling could matter a lot.

Conclusion

While on the surface the economy may seem to be doing OK, a glance beneath the bonnet of the British economy reveals a vehicle in urgent need of attention. The engine is straining – lots of employment but of questionable quality; negligible productivity growth – and the steering is awry – the public sector deficit is going in the right direction but the other sectors are out of line. Neglect the first problem and the car won't go much further. Neglect the second and another crash is not if but when.

Since 2010, the economic debate has been about how quickly to reduce the public sector deficit. Back then, the deficit was indeed the big issue. But it isn't any longer. One reason for that is that the debate has been closed by the actions of the Coalition in bringing the deficit in April 2015 to almost exactly the point that the Labour government, just before the last election, had pledged to bring it. It is worth remembering this when the pace of future deficit reduction is discussed: aggressive attempts at deficit reduction which choke off growth are likely to be abandoned after a couple of years.

The second reason is that a glance under the bonnet has revealed other, more serious problems. Carrying on as we are, with economic policies essentially unchanged, won't work and arguing that all is fine because a few key statistics are looking better is at best disingenuous and at worst positively dangerous.

The single biggest problem – and the Coalition's greatest economic failure – is the near disappearance of productivity growth. The economic growth since the end of the recession in early 2009 is down to higher, indeed record, employment. But this isn't enough. This type of economic growth is growth borne of sweat. Not only is this an unattractive prospectus, it is not the basis on which capitalism has successfully promoted itself for 70 years.

A failure to match capitalism's productivity growth from the 1960s onward was one of the factors that brought about the demise of Soviet communism. In the short term, an absence of productivity growth makes the next government's political choices – wages versus pensions, roads versus the NHS, and so on – so much harder. In the long term, the disappearance of productivity growth may even be a systemic threat.

Behind the falling public deficit lies an unbalanced economy in which labour productivity growth has stalled. This is not an economy poised for take-off as it was 1995 when the deficit also stood at 4.5%. Instead, more like 2005, it is an economy overly reliant on households spending to the hilt.

With a huge balance of payments deficit, what is needed is sustained, higher spending by companies (on investment) and the rest of the world (on UK goods and services). Yet neither of these are things which current macroeconomic fiscal or monetary policy are designed to address. Just as "unconventional" monetary policy (quantitative easing) was deployed to deal with the aftermath of the financial crisis, so unconventional economic policy will have to be deployed to deal with the unbalanced economy.

Unless this rebalancing happens, when households do eventually cut back their spending, followed inevitably by companies, so the public sector deficit will once more rise – even if in the absence of a banking crisis the rise should not be as spectacular as in 2008. The task for the next set of politicians who want to manage our economy is to explain how they are going to avoid this fate and deliver a rebalanced economy that can keep on growing steadily.